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Directive 02-12: Tax treatment of REITs

Introduction

This Directive explains and confirms the Department's tax treatment of income of Real Estate Investment Trusts, commonly known as REITs. REITs are investment vehicles created under sections 856 - 860 of the Internal Revenue Code (the Code). The Code strictly defines which entities can enjoy the benefits of REIT status. REITs have the advantage of escaping most taxation at the entity level, with REIT earnings being taxed to shareholder recipients. REITs must generally distribute at least 90% of their income to their shareholders. REITs are then allowed to deduct from their own taxable income all of those "dividends paid."

This Directive affirms that REIT income is treated generally the same under Massachusetts law as under federal law, with most income subject to single level taxation at the recipient level. Taxpayer recipients of REIT distributions (shareholders) cannot deduct the distributions from their corporate and financial institutions excise returns as dividends received. For purposes of this Directive it is assumed that the REIT entity is properly qualified under Code sections 856 - 860. The Department reserves the right to review the form, substance, and activities of any entity filing as a REIT, as well as the form, substance and activities of any entity from which a distribution is claimed as a REIT distribution, to ensure that the entity conforms to the strict REIT requirements of the Code, as well as to all other applicable federal and state law.

Issue 1

REIT returns at the entity level.

Under which provisions of the General Laws do REITs file Massachusetts tax returns at the entity level?

Directive 1

(a) REITs that are Financial Institutions. REITs that are in corporate form are taxable as financial institutions if they fall within the definition of "financial institution" set forth in G.L. c. 63, § 1. This includes REITs that operate in substantial competition with financial institutions, derive more than fifty percent of their gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities (including discounting obligations), or from other activities listed in G.L. c. 63, § 1, "financial institution." REITs that are financial institutions are required to file Form 63 FI, and must attach a copy of federal form 1120-REIT.

(b) REITs that are Business Corporations. REITs that are in corporate form, as set forth in G.L. c. 63, §§ 30.1, 30.2, that are not included in the definition of "financial institution" at G.L. c. 63, § 1 are taxed as business corporations. G.L. c. 63, § 30. REITs that are taxed as business corporations are required to file Form 355, and must attach a

copy of federal form 1120-REIT.

(c) REITs that are Corporate Trusts. REITs that are corporate trusts are exempt from tax at the entity level under G.L. c. 62, § 8(b). They must file a corporate trust return (Form 3F), filling in the “Registration” and signature sections, and must attach a copy of federal form 1120-REIT.

Discussion 1

Federally, a REIT can be a “corporation, trust, or association.” I.R.C. 856(a). Under federal law its income is always taxable as though it were the income of a corporation. I.R.C. §§ 857(b)(1), (11). Most legal entities in Massachusetts, by contrast, are taxed according to their legal form. See, e.g., G.L. c. 63, §§ 1, 30.

For Massachusetts tax purposes, REITs organized as corporations may be taxed either as financial institutions or as business corporations.^[1] G.L. c. 63, §§ 1, 30. The definition of “financial institution” includes “any . . . corporation . . . which, in substantial competition with financial institutions . . . derives more than fifty percent of its gross income, excluding nonrecurring, extraordinary items, from loan origination, from lending activities (including discounting obligations), [etc.]” G.L. c. 63, § 1 “Financial Institution” (e). For REITs organized as corporations, it is necessary to review their activities to determine whether they should properly file a financial institution excise return, or an ordinary corporate excise return.

Corporate trusts are generally subject to personal income taxes, but corporate trust REITs are exempt from them. G.L. c. 62, § 8(b). There is no provision in the corporate excise that makes corporate trust REITs subject to that tax. G.L. c. 63. Although not subject to entity level taxation, REITs that are corporate trusts must file a return. G.L. c. 62C, § 6(a). Under the general authority for prescribing forms, G.L. c. 62C, § 3, the Department will require an informational return with a copy of the REIT’s federal return.

Issue 2

Taxation of REITs at the entity level.

Is REIT income taxable at the entity level; in particular, are REITs that file as corporations and as financial institutions entitled to the dividends paid deduction?

Directive 2

With the exception of REITs that are corporate trusts, REITs are required to pay taxes at the entity level in Massachusetts. REITs that file as corporations and financial institutions are eligible for the same “dividends paid” deduction that is available at the federal level, with the result that the entity will pay no taxes on the income it distributes to shareholders.

Discussion 2

A REIT’s excise is based on its “net income.” G.L. c. 63, §§ 1, 32, 39. REITs are generally required to distribute at least 90% of their net income to shareholders, and are allowed to deduct from net income the amount distributed. I.R.C. § 857(a)(1)(A). “Net income” in Massachusetts is generally the gross income less the deductions allowable under the provisions of the Code; the statute names certain federal deductions that are not allowed. G.L. c. 63, §§ 1, 30.4. The federal “dividends paid” deduction is not among the disallowed deductions, and therefore may be taken by a REIT. G.L. c. 63, §§ 1, 30.4.

Issue 3

Taxation of REIT distributions to their recipients.

Are distributions from REITs taxable to recipients?

Directive 3	Distributions of income from REITs are not taxed at the entity level, but are taxable to the recipients. Under the personal income tax provisions, the corporate excise, and the financial institutions excise, distributions of income received from REITs are included in the recipient's gross income.
Discussion 3	Massachusetts defines "gross income" for both the corporate excise and the financial institutions excise as gross income as defined under the provisions of the Code, as amended and in effect for the taxable year. G.L. c. 63, §§ 1, 30.3. "Gross income" under the personal income tax is "the federal gross income," with certain modifications not here relevant. G.L. c. 62, § 2(a). Distributions of income received from a REIT are included in a taxpayer's federal gross income, and are thus also included in the taxpayer's Massachusetts gross income, whether the recipient is taxed under the personal income tax provisions or the corporate or financial institution excise. G.L. c. 62, § 2(a), G.L. c. 63, §§ 1, 30.3, 30.4; see I.R.C. § 61.
Issue 4	Deductibility of REIT distributions by corporate recipients. Are corporations and financial institutions that receive distributions of income from REITs allowed to deduct such distributions from gross income as dividends received?
Directive 4	No recipient, including corporations and financial institutions, that receives distributions of income from REITs is allowed to deduct such distributions from gross income as dividends received.
Discussion 4	<p>Federal law generally allows corporations to deduct their "dividends received" from gross income. See <i>generally</i> I.R.C. § 243. Massachusetts modifies the federal deduction, allowing business corporations and financial institutions to deduct 95% of dividends received. G.L. c. 63, § 30.4, G.L. c. 63, § 1, "Net income." Massachusetts has no specific definition of what comprises dividends received eligible for the deduction. Since the Massachusetts deduction is based on the federal deduction, the dividends received eligible for the deduction are the same at both the state and federal level. Cf. <i>Dow Chemical Co. v. Commissioner of Revenue</i>, 378 Mass. 254, 277 (1979) (reasoning that an item's inclusion in gross income as a dividend for federal purposes makes it included <i>as such</i> for state purposes).</p> <p>The equal treatment of dividends eligible for the dividends received deduction at the state and federal levels has particular force with respect to REITs. REITs are purely a creature of federal tax law, and terms defining them and their attributes derive from federal law. See I.R.C. § 856 <i>et seq.</i> See also <i>Commissioner of Revenue v. Franchi</i>, 423 Mass. 817, 824 (1996) ("The income to the taxpayers here was totally a creation of Federal tax law, and its classification . . . is similarly dependent.").</p> <p>Distributions of income from REITs, although called dividends in other contexts, are not treated as dividends with respect to the dividends received deduction, and are not deductible. See I.R.C., §§ 61(a), 243(d). The specific treatment of this item of income supersedes the general definition at section 61. See Treas. Reg. § 1.61-1(b) ("To the extent that another section of the Code or of the regulations thereunder, provides specific treatment for any item of income, such other provision shall apply notwithstanding section 61 and the regulations thereunder.") Because REIT distributions are not deductible as dividends received at the federal level, they are also not deductible as dividends received in Massachusetts. G.L. c. 63, § 30.4, G.L. c. 63, § 1, "Net income." This balances the fact that on the entity level the REIT is given the special benefit of deducting the same</p>

amounts as “dividends paid,” thus ensuring that the income is subject to a single level of taxation only. See Discussion 2, above. The purpose of the dividends received deduction is not to allow income to escape taxation altogether, but rather to ensure that income is taxed only once. See *New York Times Sales, Inc. v. Commissioner of Revenue*, 40 Mass.App.Ct. 749, 754 (1996), citing *Dow Chem. Co. v. Commissioner of Rev.*, 378 Mass. 254, 268 (1979)(“The reason for the intercorporate dividend deduction is to prevent multiple taxation of corporate income. Without the deduction, three categories of taxpayers -- the subsidiary corporation, the parent corporation, and the parent's shareholders -- would each be subject to taxation on the same basic income.”).

/s/ Alan L. LeBovidge

Alan L . LeBovidge

Commissioner of Revenue

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[1] There is no contradiction between the fact that under federal law REITs may not be financial institutions, but under Massachusetts law they may be financial institutions. See *generally* I.R.C. § 856(a)(4)(A), I.R.C. §§ 856-860, G.L. c. 63, §§ 1 - 7. The meaning of “financial institution” is completely different between the federal and state taxing schemes. *Id.*